

September 2005

Honorable Mayor, City Council,
And Citizens of the City of Carlsbad
City of Carlsbad
1635 Faraday Avenue
Carlsbad, CA 92008-7314

**City Treasurer Letter of Transmittal
2004-2005 Annual Report of Investments**

I am pleased to present the Annual Report of Investments for the City of Carlsbad for the fiscal year ended June 30, 2005 (FY 04-05). The report is intended to provide reliable information as a basis for reviewing portfolio performance and making management decisions. It also provides an archival reference.

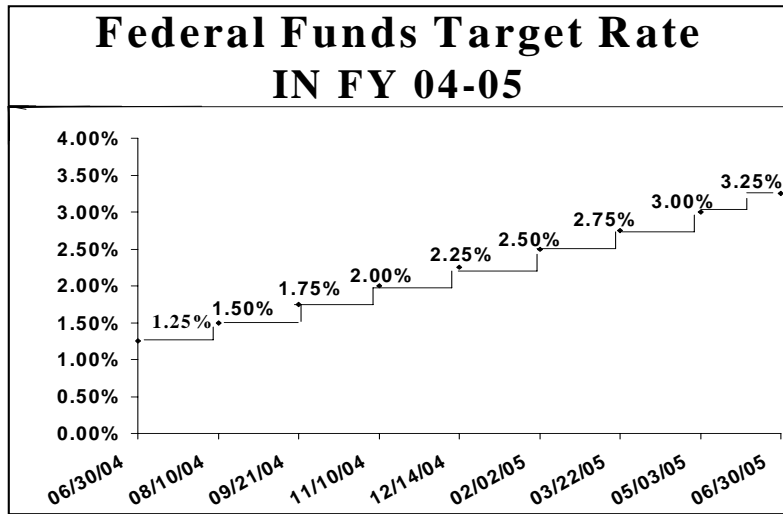
The City Treasurer is charged with the design of an effective cash management and investment program for the City of Carlsbad and all of its agencies. Among other activities, this includes arranging for banking services; forecasting all cash receipts and expenditures; investing all inactive cash; managing investment risk exposures; and reporting all investment activities.

This report summarizes and analyzes the activities of the investment portfolio for FY 04-05. Total portfolio assets, asset allocations, yields achieved, cash incomes, risk exposures and cash flows are presented. To give perspectives to these measurements, movements in market interest rates are provided for the fiscal year ended June 30, 2005. Comparisons are also made with the preceding fiscal years. Finally, a statement is offered regarding the prospects for the fiscal year 2005-2006 (FY 05-06) commencing July 1, 2005.

James M. Stanton
City Treasurer

CITY TREASURER ANNUAL REPORT OF INVESTMENT PORTFOLIO FOR THE FISCAL YEAR ENDED JUNE 30, 2005

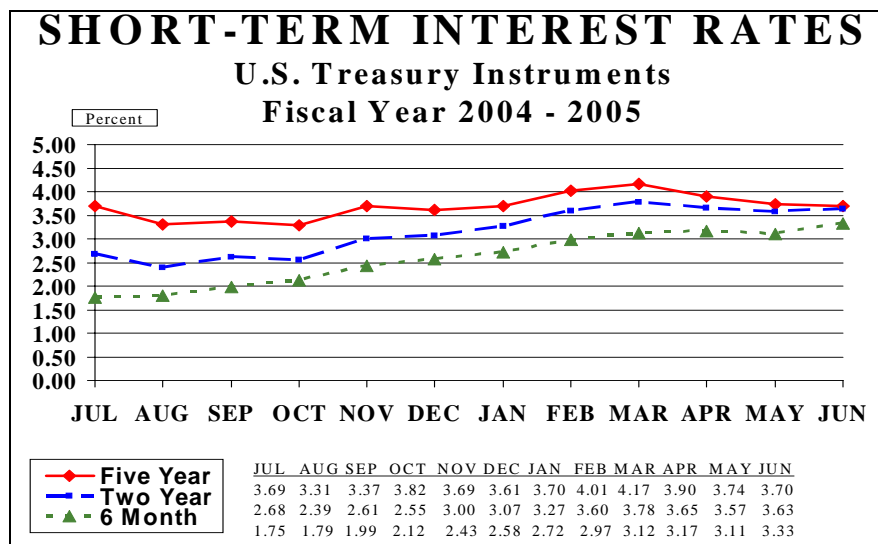
FY04-05 MARKET REVIEW

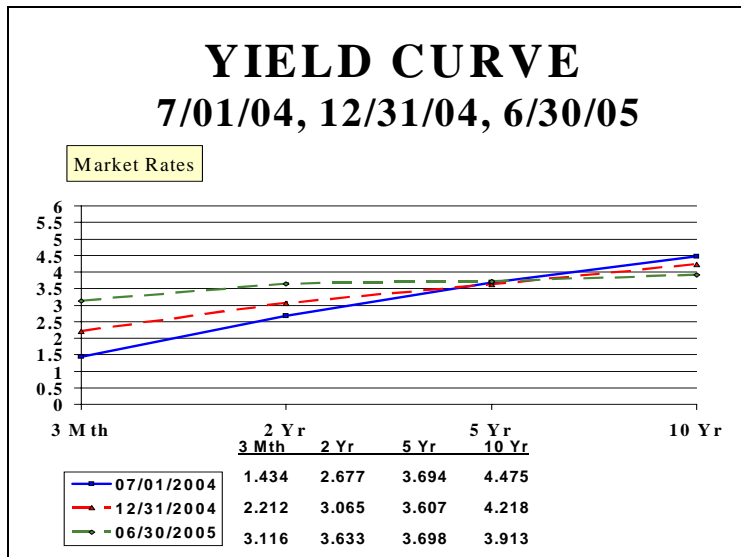


Federal funds rate is a key money market rate that correlates with rates of other short-term credit arrangements. It is the interest rate that banks charge each other for overnight loans. In fiscal year 04-05 the Federal Reserve increased the federal funds rate eight times, each by 25 basis points for a total of 200 basis points. As a result, the federal funds rate increased from 1.25%

June 30, 2004 to 3.25% June 30, 2005.

Changes in short-term market interest rates are usually affected by the actions of the Federal Reserve. Six-month and two year market rates increased over the course of the fiscal year. Five year market rates, however, ended the fiscal year with the same rate it started. Longer-term market rates were relatively unaffected by the actions of the Federal Reserve. Chairman Greenspan described this as a conundrum.



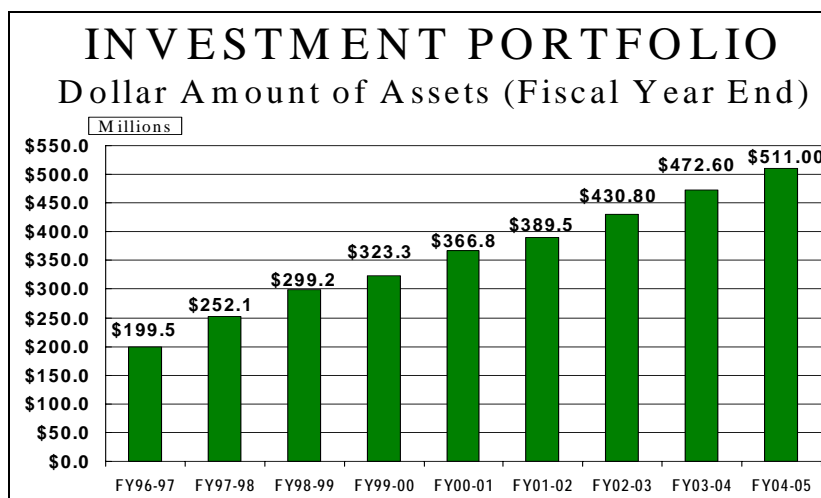


The yield curve is a graphic presentation of the difference between short-term and longer-term interest rates of U.S. Treasury instruments on a given day. Financial analysts use it to assess the market's expectation of recession or inflation. The normal shape of the yield curve has a moderately upward slope, with short-term rates lower than longer-term rates. If the upward slope steepens, the

financial markets believe inflation may occur. An inverted yield curve is when short-term market rates are greater than longer-term market rates. An inverted curve indicates that the financial markets expect a slower economy, if not a recession.

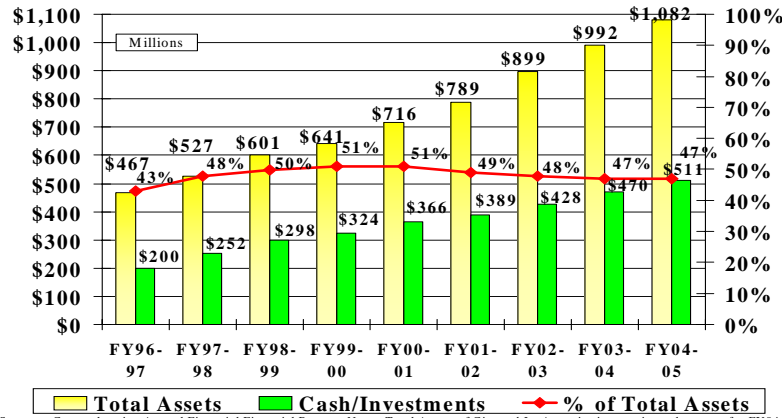
At the beginning of FY 04-05 (July 1, 2004), the yield curve had a moderate upward slope, indicating a slight bias on the side of inflation. At the middle of FY 04-05 (December 31, 2004) the upward slope of the yield curve became much less. As FY 04-05 ended, the yield curve was almost flat. On June 30, 2005, the flat yield curve was indicating that the economy was close to equilibrium, with no discernible bias toward either inflation or recession.

PORTFOLIO ANALYSIS



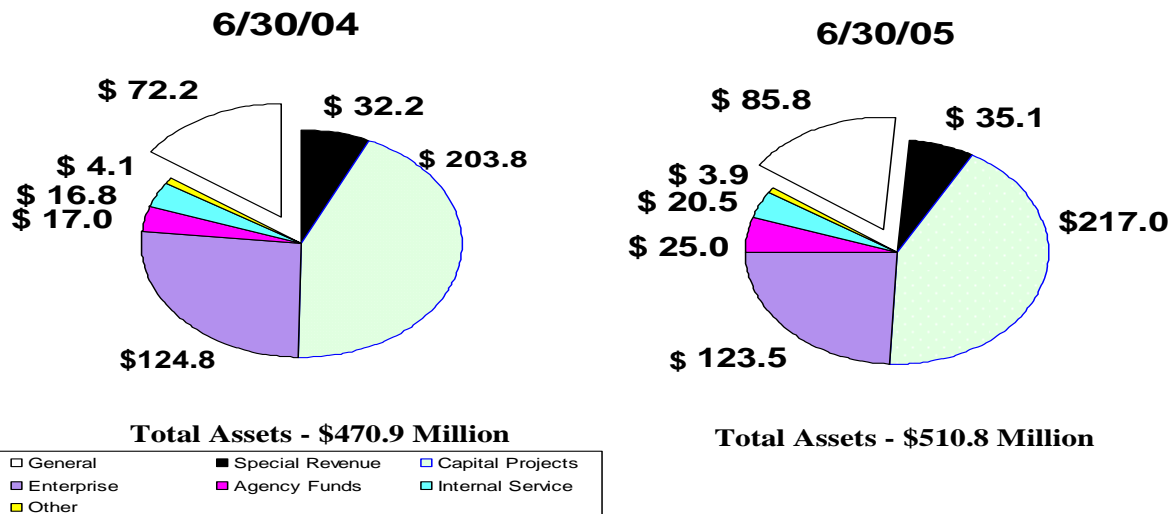
Total assets in the investment portfolio stood at \$511 million at the end of the fiscal year, an increase of 8%. The \$511 million is again a record amount for the portfolio. Commencing with FY 96-97, year-over-year percentage increases have been 32%, 26%, 19%, 8%, 13%, 6%, 11%, 10%, and 8%.

CASH/INVESTMENTS RELATIVE TO TOTAL ASSETS OF CITY AND ITS AGENCIES*



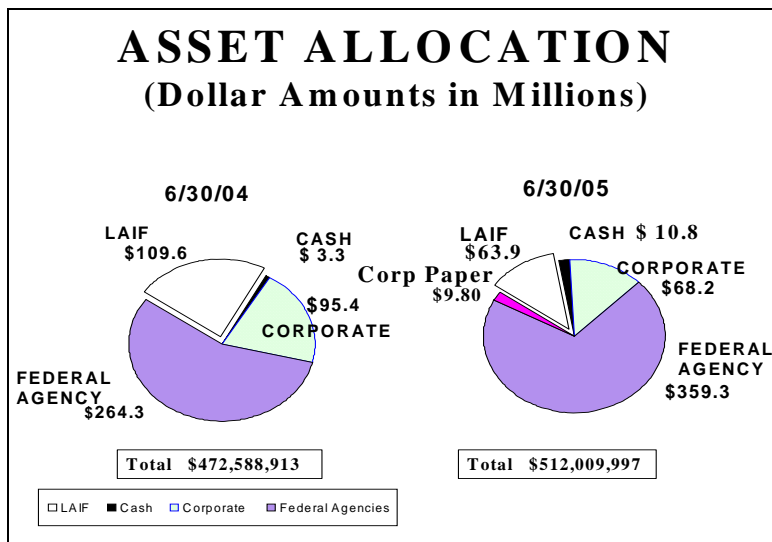
The City publishes a Comprehensive Annual Financial Report (CAFR) at the end of each fiscal year. Among other information, CAFR presents a balance sheet showing the total assets owned by the City and all its agencies. At the end of FY 04-05, cash and investments managed by the City Treasurer represent 47% of all assets reported by the City and its agencies.

SOURCE OF POOL ASSETS (Dollar Amounts in Millions)



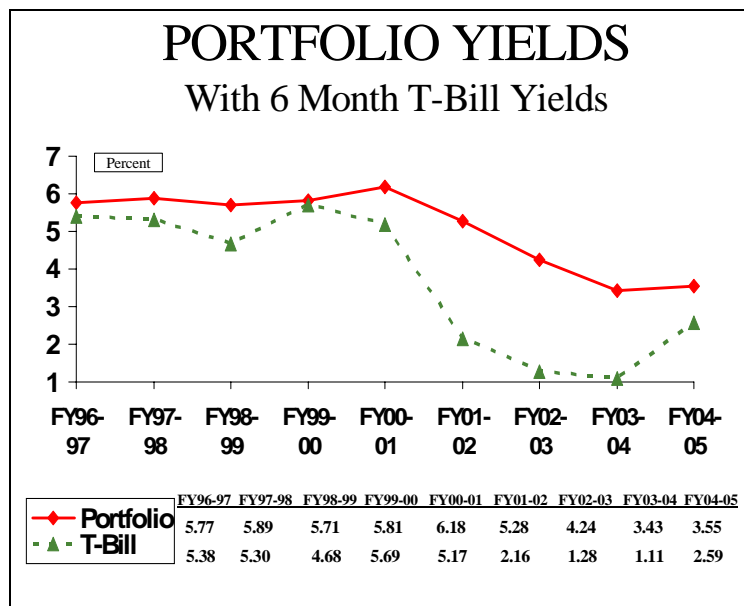
The portfolio is an internal investment pool that uses the inactive cash from the various funds of all City agencies, including the City, the Water District, and the Redevelopment Agency. Total portfolio assets increased by 8% from the previous fiscal year. The top three sources of portfolio assets are the Capital Projects fund (\$217.0 million, 42% of the total), followed by the Enterprise fund (\$123.5 million, 24% of the total), and the General fund (\$85.8 million, 17% of the total). Together, these three funds account for 83% of total portfolio assets.

Investments are made in financial instruments authorized by the City's Investment Policy and the California State Government Code. With the exception of bank deposits and deposits in the California State Local Agency Investment Fund (LAIF), all investments are in fixed-income instruments with known maturity dates.



At the end of FY 04-05 (June 30, 2005), 70% of portfolio assets were invested in federal agencies, 13% in corporate notes, and 12% in LAIF. The allocation of assets to federal agencies increased, while the allocation to both corporate notes and LAIF both decreased from the previous fiscal year. This reflected the decrease in interest rate spreads for corporate notes relative to

U. S. Treasuries and the increase in short term interest rates relative to LAIF. Within the asset category of federal agencies, investments in the Federal Home Loan Mortgage Corporation, the Federal Home Loan Bank, the Federal National Mortgage Association, and the Federal Farm Credit Bank, constituted 37.4%, 34.6%, 26.3% and 1.7% of the total, respectively. Federal agencies are creations of the U. S. Congress and include agencies and government-sponsored enterprises.

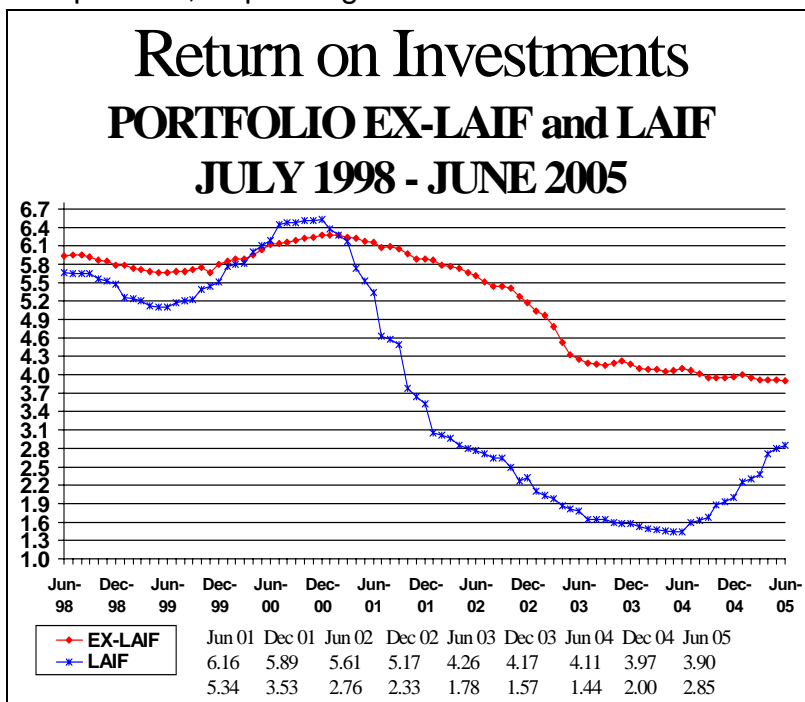


The average return of the portfolio for FY 04-05 increased to 3.55% from 3.43% the year before. The portfolio yield is heavily influenced by changes in short-term market interest rates since approximately 29% of total investments were required to mature within one year. The average interest rate for six-month U.S. Treasury Bills increased to 2.59% from 1.11% the year previous.

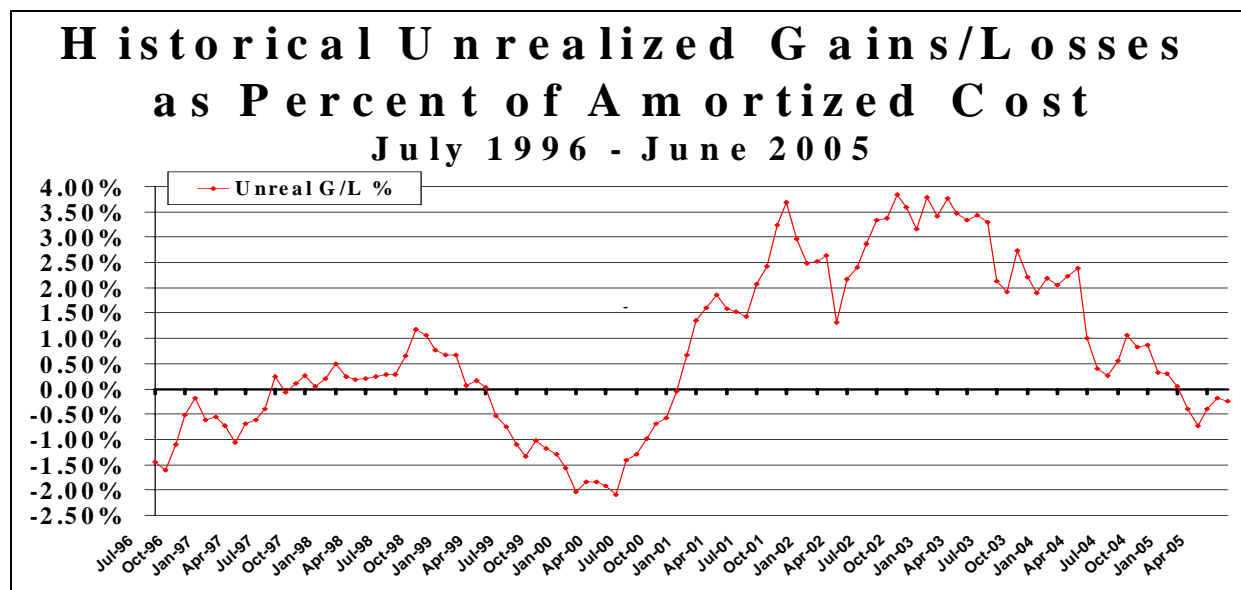
Return on investments is shown in two categories: (1) LAIF deposits and (2) all other investments. LAIF is an acronym for Local Agency Investment Fund. It is an investment pool managed by the California State Treasurer. The LAIF investment pool is very liquid with average investments usually maturing in six to seven months. City deposits in LAIF provide a desired measure of liquidity at attractive short-term rates, and typically comprise 10% to 20% of the total portfolio, depending on market interest rates at the time. In many respects, City deposits in LAIF are comparable to having a checking account that earns interest similar to U. S Treasury instruments maturing in one to five years.

Compared to LAIF deposits, all other City investments will typically earn 40 basis points more. However, when market interest rates rise rapidly, earnings on LAIF deposits will briefly exceed the earnings on all other portfolio investments.

On the other side, when market rates have either been stable or have decreased rapidly, earnings on other investments can be anywhere from 30 basis points to 270 basis points (2.7%) greater than LAIF. LAIF turns over its investments in one-third the time and responds to changes in market interest rates much quicker than other investments in the portfolio. Reacting to short-term interest rates in FY04-05 returns on LAIF investments increased while returns on other portfolio investments were relatively stable. This spread will likely decrease further as short-term rates continue to increase in FY05-06. Return on LAIF deposits may again exceed the return on all other portfolio investments.



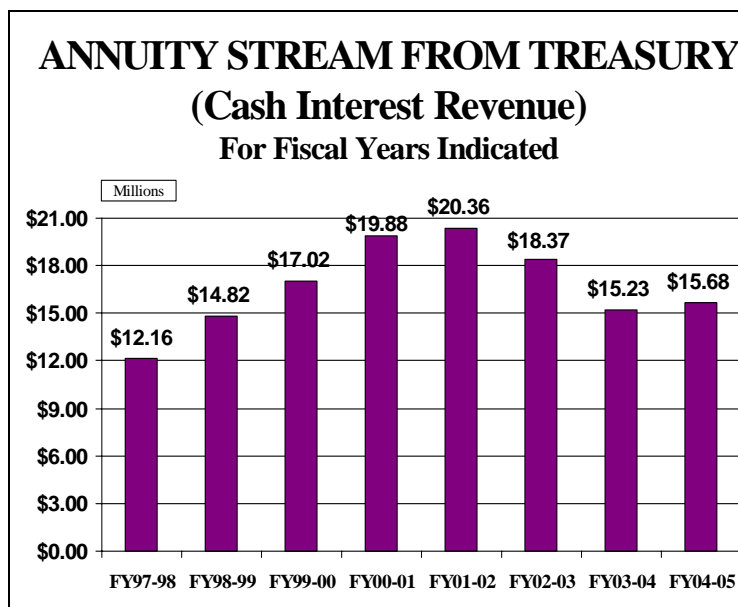
This graph shows the percent change in value of the portfolio over the last several years. Investments gain and lose value subsequent to purchase because of changes in market interest rates. When market interest rates decrease, investments made earlier at higher rates will gain value. The reverse is true when market interest rates increase. Accountants refer to these changes in value as unrealized gains and unrealized losses; newspapers report them as paper gains and paper losses. Changes in value caused by changes in market interest rates are normal and are expected. Excluding investments in LAIF, all investments are exposed to this interest rate risk.



With a buy and hold policy, an objective of the City's Investment Policy is to achieve an average market rate of return over the economic cycle. The success in achieving this objective can be approximated with having unrealized gains and losses that are relatively equal over time. Tracking and measuring unrealized gains and losses could also reveal any presence of high-risk investments in the portfolio. The changes in asset values shown in the graph indicate that portfolio investments are within the acceptable interest rate risk identified in the City's Investment Policy.

The total portfolio had an unrealized loss in the latter part of FY 04-05. This unrealized loss occurred as investments with high interest rates matured and were reinvested in lower market rates. It is likely that the unrealized losses will grow in FY05-06.

Cash income from portfolio investments represents an annuity stream of revenues from the Treasury. This annuity stream totaled \$15.7 million, an increase of approximately \$400,000 from the previous fiscal year. Of the total cash interest revenues earned by the portfolio in FY 04-05, over \$2.3 million was credited to the General fund. Cash income is a function of assets in the portfolio, the market interest rates at the time of the investments, and the interest payment schedules of the issues.



FY 05-06 PREVIEW

National and international economic forces are the primary influences on market interest rates. It is anticipated that domestic economic growth will continue and that the Federal Reserve will continue to raise the federal funds rate gradually in 25 basis points increments. Short-term market rates will increase faster than long term rates resulting in a higher but flatter yield curve. The federal funds rate on June 30, 2005 increased to 3.25% from 3.00%.

Approximately \$64 million of investments with fixed maturity dates will mature in FY 05-06. An additional \$70 million may be called. Proceeds from these investments will be reinvested at market rates lower than the maturing or called investments. Yields on our LAIF investments are expected to be higher.

At the end of FY 04-05 (June 30, 2005), LAIF investments had a yield of 2.85%, and all other investments had a yield of 3.90%. LAIF investment yield will increase to 3.5% until March 2006 and then decrease to 3.2% by the end of the FY05-06 (June 30, 2006). Yields on investments other than LAIF will decrease to 3.80% by the end of the fiscal year.

Throughout the fiscal year ending June 30, 2005 the yield of the total portfolio averaged 3.55%. During fiscal year July 1, 2005 to June 30, 2006 (FY05-06), the total portfolio is projected to have an average yield of approximately 3.65%.

Total assets in the investment portfolio stood at approximately \$511 million at the end of FY 04-05. This is expected to increase to approximately \$540 million by the end of FY

05-06. Assessed property values are forecasted to increase by about 10.1%, while sales tax revenues and transient occupancy tax (TOT) revenues are expected to increase by 5.3% and 4.8%, respectively. Additionally, interest revenue earned from portfolio investments in FY 05-06 should approximate \$17 million.

APPENDICES TO ANNUAL REPORT OF INVESTMENT PORTFOLIO

APPENDIX A: RISK MANAGEMENT AND DISCLOSURE

All investments are exposed to risk of some type. The objective of risk management is to identify the risks involved and establish acceptable levels of risks that are consistent with the City's investment objectives. Risk management includes managing, measuring, monitoring, and reporting the various risks to which portfolio investments are exposed.

Portfolio investments are exposed to the following types of risks:

- A. Credit risk.
 - a. Custodial credit risk.
 - a) Investments.
 - b) Deposits.
 - b. Default credit risk.
 - c. Concentration credit risk.
- B. Interest rate risk.

As of June 30, 2005, the portfolio had the following investments and cash in its internal investment pool.

| <u>Investment</u> | <u>Maturities</u> | <u>Market Value</u> | <u>Market Value Gain (Loss)</u> |
|-------------------|----------------------|-----------------------|-------------------------------------|
| U. S. agencies | July 2005 – May 2010 | \$ 357,804,768 | \$ (1,625,893) |
| Corporate Notes | July 2005 – Mar 2008 | 67,416,719 | 604,077 |
| Corporate Paper | July 2005 – Sep 2005 | 9,941,000 | (5,363) |
| LAIF | | 63,863,000 | -- |
| Sweep accounts | | 9,864,660 | -- |
| Cash accounts | | <u>906,935</u> | <u>--</u> |
| Total | | <u>\$ 509,797,083</u> | <u>\$ (1,027,179)</u> |

Disclosures

Custodial Credit Risk (Investments). The City uses a third party custody and safekeeping service for its investment securities. The Union Bank of California (UBC) is under contract to provide these custodial services. Custodial credit risk is the risk that the City will not be able to recover the value of its investments in the event of a UBC

failure. All City investments held in custody and safekeeping by UBC are held in the name of the City and are segregated from securities owned by the bank. This is the lowest level of custodial credit risk exposure.

Custodial Credit Risk (Deposits). The City maintains cash accounts at Wells Fargo Bank (WFB) and UBC. At the conclusion of each business day, balances in these accounts are “swept” into overnight investments. These overnight investments are in either U. S. government securities (guaranteed) or in U. S. agency securities (government sponsored). The California Code and the City’s Investment Policy authorize both of these types of investments. A small amount of cash is not swept from the WFB checking accounts to cover checks that may be presented for payment. Amounts up to \$100,000 are FDIC insured.

Default Credit Risk. Default credit risk is the risk that the issuer of the security does not pay either the interest or the principal when due. The debts of most U. S. agencies are not backed by the full faith and credit of the federal government; however, because the agencies are U. S. Government-sponsored, they carry AAA credit ratings. The default credit risk of these investments is minimal.

California state code limits investments in medium-term corporate notes to the top three credit ratings (AAA, AA, and A). It is the City’s policy, however, to limit investments to the top two credit ratings (AAA and AA). As of June 30, 2005, approximately 46% of the investments in medium-term corporate notes had credit ratings below the AA limit set by the City’s Investment Policy. All of these investments were made when the credit ratings were either AAA or AA. California state code and the City’s Investment Policy allow the City Treasurer to determine the course of action to correct exceptions to the Policy. It is the intent of the City Treasurer to hold these investments in the portfolio until maturity unless events indicate they should be sold. The default credit risk for corporate notes with a credit rating of single A is lower than U. S. federal agencies or LAIF, but is considered by the City Treasurer to be within acceptable limits for purposes of holding to maturity. A credit rating of single A is within State code requirements.

The Local Agency Investment Fund (LAIF) is an investment pool managed by the California State Treasurer. Its investments are short-term and follow the investment requirements of the State. As of June 30, 2005, the average maturity of the LAIF investments was 151 days. The State Treasurer does not contract for a credit rating to be assessed for LAIF. California state code section 16429.3 specifically excludes LAIF deposits from being transferred, loaned, impounded or seized by any state agency or official. The State Treasurer has made a public written statement saying that he would oppose any attempt to change this section of the State code. The default credit risk of LAIF is minimal.

Concentration Credit Risk. Concentration credit risk is the heightened risk of potential loss when investments are concentrated in one issuer. The California state code does not identify a specific percentage that indicates when concentration risk is present for any one issuer. The state code does, however, require that total

investments in medium-term corporate notes of all issuers not exceed 30% of the portfolio. As of June 30, 2005, approximately 13% of the City's total portfolio investments were in medium-term corporate notes.

For concentration of investments in any one issuer, the City's Investment Policy requires that no more than 5% of investments in corporate notes be in any one issuer. There is no similar requirement in either the state code or the City's Investment Policy for U. S. agencies. As of June 30, 2005, no investments in any one corporate issuer exceeded 5% of total portfolio investments.

Interest Rate Risk. Interest rate risk is the risk that investments will lose market value because of increases in market interest rates. A rise in market interest rates will cause the market value of investments made earlier at lower interest rates to lose value. The reverse will cause a gain in market value. As of June 30, 2005, the portfolio had a .2% loss in market value.

The City's investment policy has adopted two means of limiting its exposure to market value losses caused by rising market interest rates: (1) Limiting total portfolio investments to a maximum modified duration of 2.2, and (2) requiring maturing investments within one year be equal to an amount that is not less than the current operating budget (\$148,000,000). As of June 30, 2005, the modified duration of the portfolio was 1.89, within the required maximum of 2.2. Investments maturing within one year were \$159,864,000, exceeding the required minimum of \$148,000,000. The City's exposure to interest rate risk is within acceptable limits.

APPENDIX B: PORTFOLIO ACTIVITIES FOR FISCAL YEAR ENDED JUNE 30, 2005

The City's portfolio balance increased 8% from \$472.6 million to \$512.0 million in fiscal year 2004-05. The increase of \$39 million does little to show the volume of cash that flows in and out of the portfolio in the course of one fiscal year. The following table illustrates that the City Treasurer managed during fiscal year 2004-05 over two billion dollars of cash inflows and cash outflows prompting investment decisions.

Cash inflows:

| | |
|-----------------------|------------------------|
| Bond Maturities | \$ 38,075,000 |
| Bond Calls | 90,715,000 |
| Bond Sales | 6,000,000 |
| LAIF Withdrawals | 184,577,000 |
| Sweep | 709,761,000 |
| Interest Income | 15,679,000 |
| Bond Purchases | 214,256,000 |
| LAIF Investments | 138,800,000 |
| Sweep Investments | 718,356,000 |
| Cash Investment (net) | <u>(1,070,000)</u> |
| Total | <u>\$2,115,149,000</u> |